

G.E.B.

Groupement Européen de Banques



EU Position Paper

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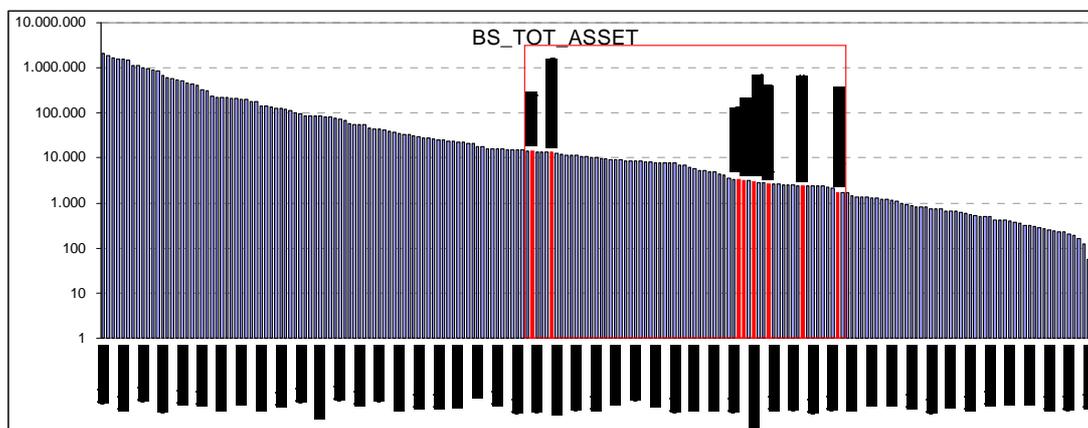
Introduction to the GEB

The Groupement Européen de Banques (hereinafter “GEB”) is a group of privately owned small and medium sized banks cooperating with the aim of exchanging experiences on how to best serve customers.

It was founded in the late seventies (*details in appendix*) and it currently encompasses 8 member banks from 8 different EU countries:

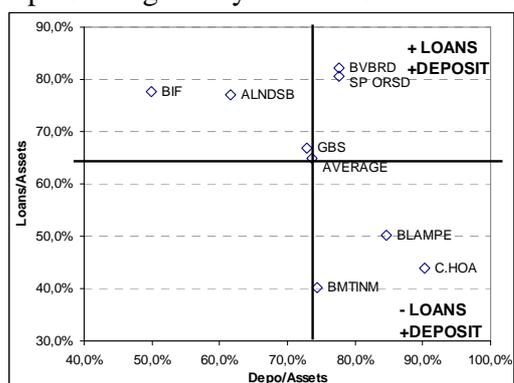
Ålandsbanken (Finland); Banca Sella Holding (Italy); Banque Martin Maurel (France); Banif (Portugal); Bank J. Van Breda & Co. (Belgium); Bankhaus Lampe KG. (Germany); C. Hoare & Co. (United Kingdom); Sparbanken Oresund (Sweden). For short profiles of single member banks of GEB, please refer to Appendix 1.

GEB members have assets ranging from 1,8 to 14,4 bln euros, thus qualifying, according to this measure¹, as medium and small banks in the EU scenario (graph below, in mln €, log scale), even if some of them have an international presence and relevance at national level.



Source: Bloomberg and company data, 2009

GEB members have very heterogeneous business models (graph below), thus representing a truly international and unbiased voice from the industry.



Source: company data, 2009

¹ The graph is built on a 202 banks sample available from the Bloomberg provider at EU level: the sample can be considered as a proxy of banks with some financial relevance in the area but it is obviously upward biased, being the total banking population much wider in EU.

1. Foreword

Small and medium sized banks (“SMB” hereinafter) are essential to prevent excessive market concentration (as a consequence of “dimensional” incentives), retain an adequate market structure, preserve competition in the banking sector and provide better customer service.

According to a document by the ECB² medium sized banks (having total assets between 2 and 198 Bln € as of end of 2009) are 655 banks, represent around 18% of the total banking population in EU27, holding around 22% of the assets in the industry.

Number of credit institutions EU27	2009	in %
Big (Assets>198 B)	40	1,1%
Medium (Assets 2-198 B)	655	17,7%
Small (Assets <2B)	3.001	81,2%
TOTAL	3.696	100%

	Assets, 2009	in % of system
Big	26.025	75,1%
Medium	7.658	22,1%
Small	980	2,8%
TOTAL	34.663	100%

As a comprehensive recent BIS study clearly shows, SMBs are usually characterized by more traditional banking business models, a high deposit/asset base, a low short term incidence on funding and a higher share of income from commercial interest margins³.

SMBs thus play an important role in savings collection and in lending to smaller and medium sized companies. Because of their strong knowledge of the local economy; they are as well a stability element in the banking system, since they show continuity in business partnerships. Business models and internal incentive systems in SMBs, being generally traditional and relationship based, are long term oriented, thus insulating stakeholders from most of the short term effects sometimes determined by financial markets. In this sense, SMBs embody to many respects the “community bank” role whose

² EU Banking Sector Stability, 9/2010: “large domestic banks are defined as banks with assets totaling more than 0.5% of the total consolidated assets of EU banks, whereas medium-sized banks have total assets of between 0.005% and 0.5% of total consolidated assets. Banks with total assets of less than 0.005% of total consolidated assets are considered small..... In the 2010 collection exercise (concerning end-2009 data), the thresholds were computed on the basis of total assets of €39,589 billion, as recorded in the 2009 data collection exercise”.

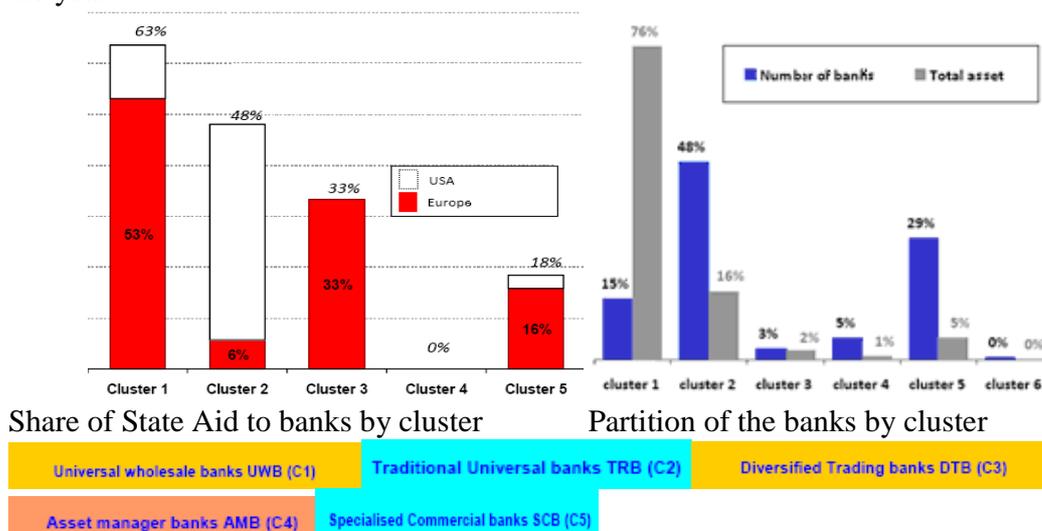
³ L.Gambacorta and D.Marques-Ibanez in BIS Working Paper N345, may 2011, The very comprehensive study (1008 banks for a 10 years quarterly time series), shows that the SIZE variable (total asset) is significantly inversely related to the deposit/asset ratio and positively related to short term funding and Non Interest Income. Thus traditional deposit-based commercial banking is more often associated with small bank dimensions.

importance to the whole economy and to small business is given a clear representation by B. Bernanke in his speech to Independent Community Bankers of America (ICBA)⁴

Moreover, SMB usually have a lower complexity in balance sheets, allowing a naturally higher transparency to all stakeholders; in addition acting in a prudential and disciplined manner is usually more necessary to their survival than complex statistical models because of their direct knowledge of final customers.

In the recent financial crisis, small and medium banks have not been much supported by specific government interventions but have been at least as active as (if not more than) large and supported banks in feeding the economy in one of its worst moments of the modern era⁵. In the following graphs by ABI⁶, the Italian Banking Association, it is shown that specialised commercial banks (Cluster 5), universal traditional banks (Cluster 2) and small asset managers (Cluster 4), representing respectively 5%, 16% and 1% in total assets of the pool (right hand graph), have received a marginal part of the state aids in EU (left hand graph, in red State Aids by EU, in white by US).

As shown in appendix 3, the banks in Cluster 1, having received State aids, have performed much better than others in 2010, recovering losses of the previous year. The most traditional banks (Specialised commercial in Cluster 5) have performed the worst in the year.



(source EBR, ABI - Associazione Bancaria Italiana)

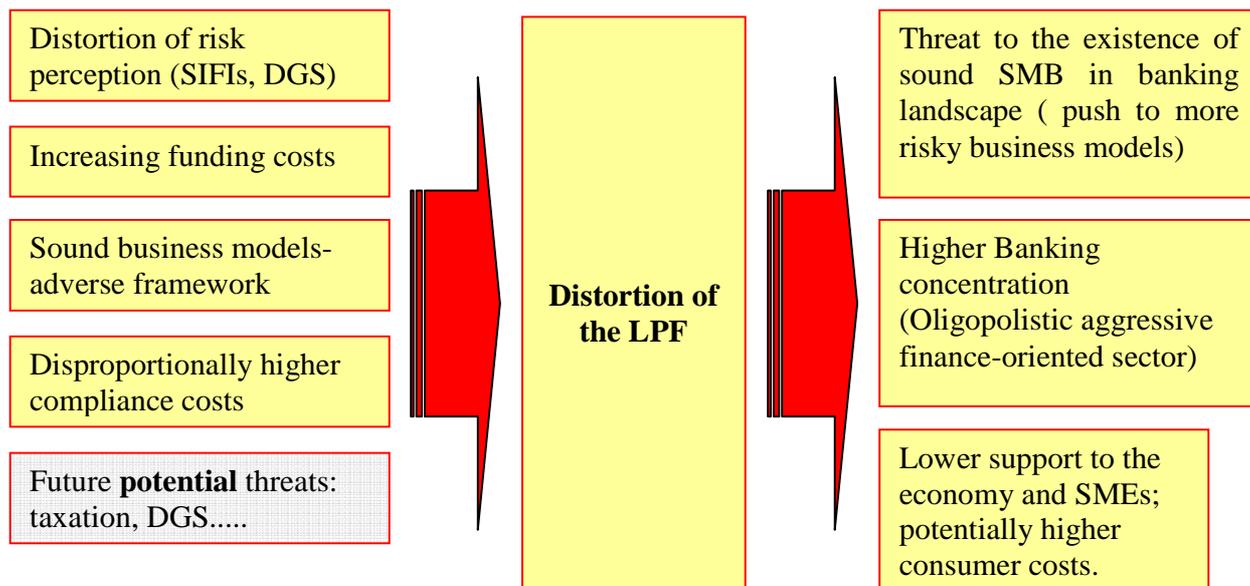
⁴ “Community Banking in a period of recovery and change”, Ben Bernanke before ICBA, March 23, 2011. “To me, the title of the 2009 ICBA annual report, *Empowering Main Street*, is a concise and accurate description of the critical role that community banks play in the U.S. economy. Community bankers live and work where they do business, and their institutions have deep roots, sometimes established over several generations. They know their customers and the local economy. Relationship banking is therefore at the core of community banking. The largest banks typically rely heavily on statistical models to assess borrowers’ capital, collateral, and capacity to repay, and those approaches can add value, but banks whose headquarters and key decision makers are hundreds or thousands of miles away inevitably lack the in-depth local knowledge that community banks use to assess character and conditions when making credit...”

⁵ L.Gambacorta and D.Marques-Ibanez in BIS Working Paper N345: SIZE variable is positively significantly related to RESCUE (dummy that takes 1 if saved by government).

⁶ “Crescita macroeconomica e trattamento prudenziale dei prestiti alle PMI: il PMI Supporting Factor”, Associazione Bancaria Italiana 6/2011; the graph is based on 360 banks from EU and USA.

Also by virtue of all this, public opinion is generally in favour of small banks even when a non client. And being usually not listed, they may have a long term commitment to strategy and are less affected by market volatility.

2. Summary of concerns



At GEB level, we are currently observing an exceptionally **serious deterioration in the Level Playing Field** (hereinafter LPF) in the banking sector, disadvantaging more prudential business models and smaller traditional banks, undermining our capability, as SMBs, to support the economy and pressuring us to take undesired higher risks.

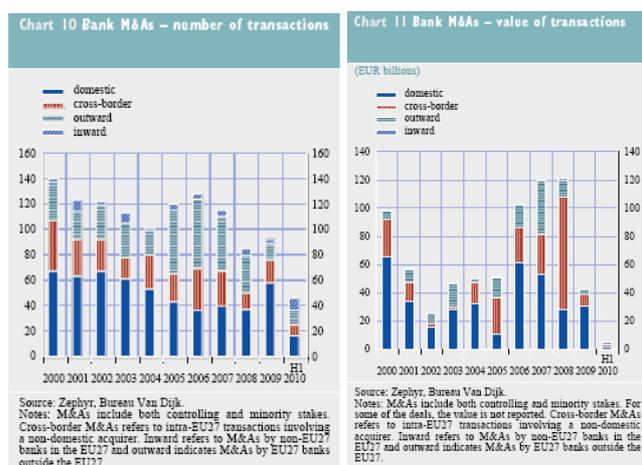
Prudential banking business models like traditional lending-oriented banking and pure liquidity sound private banking, historically characterised by customer oriented market practices and sound liquidity, are currently experiencing an exceptionally tough environment which can be considered a direct consequence of the biases embedded in the previous regulatory framework, of the recent crisis and of the following exceptional measures .

These disadvantageous effects, are even more severe for smaller and medium banks, with which traditional business models are more often associated, mainly because of **disproportionally higher compliance costs** and **funding costs** for SMBs. These are in turn mainly related to the **lack of proportionality in regulation** and **implicit/explicit support** to large banks with higher risk models that cause a higher risk perception by counterparts with regard to SMBs.

This adds on an already tough environment, characterized by historically low interest rates and margins and a traditional **lending-adverse regulatory framework**, the latter being an ante-crisis heritage (Basel2) not materially improved by recent measures. On the

contrary, some of the measures currently under discussion (additional taxation on the whole sector, Deposit Guarantee Schemes) threaten to push the burden on traditional business models and SMBs towards higher levels.

As a result of this and as an unintended consequence of the exceptional countermeasure introduced in the aftermath of the crisis, we could soon witness the **disappearance of prudential SMBs** from the banking industry, with their absorption in **other riskier** (and larger) **business models** on the market. One possible evidence of this comes from mergers and acquisitions activity in the EU banking sector, increasingly involving smaller banks, as shown in the graphs below by the ECB⁷.



This could finally transform the banking industry in an **oligopolistic and mainly aggressive finance-oriented sector**, with potential consequences on competition, consumer costs, unemployment levels, systemic soundness, economy and SMEs support.

A very vivid representation of this fundamental issue is provided by Thomas M. Hoenig President and Chief Executive Officer, Federal Reserve Bank of Kansas City⁸

“As late as 1980, the U.S. banking industry was relatively dispersed, with 14,000 commercial banks and the assets of the five largest amounting to 29 percent of total banking organization assets and 14 percent of GDP.

Today, we have a far more concentrated and less competitive banking system. There are fewer banks operating across the country, and the five largest institutions control more than half of the industry’s assets, which is equal to almost 60 percent of GDP. The largest 20 institutions control 80 percent of the industry’s assets, which amounts to about 86 percent of GDP.

⁷ EU banking structure, sept2010. In 2009 the number of transactions has materially increased at domestic level while the value of these transactions marginally increased implying a lower value per transaction, to mirror decreased valuation and/or lower size of involved companies.

⁸ “Do SIFIs Have a Future?”, Washington, D.C. , June 27, 2011

Here's the irony: This marked increase in concentrated power, and therefore, more concentrated risk, reflects past efforts to assure greater economic stability. This might best be described as “good intentions/bad outcomes” syndrome. “

It is thus of primary importance, in our opinion, to avoid in the new regulation lending adverse measures, promptly rebalancing the competitive advantages given to large companies and monitor the health of smaller players in the banking sector.

A general principle of causation would suggest that banks that caused the crisis should be called to pay for it and should not, on the contrary, benefit from its consequences. The exceptional suspension of the exit rule from the market for (f)ailing enterprises is now, on the contrary, leading to a privileged competitive status of some players, whose price all others are called to pay, generating dangerous inefficiencies and capital misallocation in the industry.

It is not acceptable, for instance, that the restructuring costs for individual systemically important market players resulting from their excessive risk appetite must be suffered by the entire banking sector. According to the principle of causation, those banks or groups of banks that have caused the costs of the crisis must repay these costs or make provisions for future crises of this category. This is closely connected to a second regulatory issue: the Government support measures taken so far must not lead to competitive distortions. And Government support funds should never be passed over the counter, as welcome gifts for new clients.

3. Details

3.1 *Distortion of risk perception*

During the latest financial crisis and in the aftermath, regulators and governments reinforced safety nets for the banking industry through:

- exceptional public intervention –State aid- was required for the survival of SIFI's which were all banks with riskier and more complex business models
- deposit guarantee schemes (DGS) were expanded

These measures were necessary to protect depositors and to give confidence to the general public in order to avoid irrational behaviours and bank runs. Unfortunately they had the perverse side effect that the risk perception of SMBs increased.

In an environment of generally increased risk perception on banks, to which large finance-oriented banks have made largest contributions, SMBs are currently attributed a higher risk because of **lower state support probability**. This further reduces the access to funding channels (already lower for SMBs), disproportionately increasing related costs. This attitude- **based on pure dimensional factors** -is clearly represented by the recent action by Danish authorities and the recent downgrades by Moody's on Spanish banks.

Example Danish Amagerbanken

On February 2011 the Danish authorities used the recently created bank resolution framework (Bank Package III) in relation to the failure of the small bank (4,5 bln in assets as of 2009), imposing a 41% write-down of senior debt and unguaranteed deposits and sending a strong signal that it may do so again in the future⁹. A prompt downgrade by the rating agency Moody's on Danish banks followed. Spokespersons from Norwegian and Swedish Financial Supervisory Authorities are reported to have said that they could follow the Danish resolution approach.

Example Moody's downgrade because of lower probability of state aid
On March 24, 2011 Moody's downgraded small Spanish Banks also threatening massive downgrades for non systemically relevant banks in other countries on the hypothesis of a lesser support by states in case of insolvency.

Deposit Guarantee Schemes in the end becomes a cross-subsidy from low-risk to high-risk institutions, promoting risk taking. Depositors know that they will be repaid and require no longer a risk premium. The competitive advantage of low risk banks (SMBs) is consequently faded out. Higher risk banks are no longer punished for risk-taking and it is an incentive to incur greater risks, hence even amplifying systemic risk. This **moral hazard effect** has been recognized by numerous empirical and academic studies.

This moral hazard effect should be dampened by founding the contribution to the scheme on the risk profile of a bank. Historically contributions to DGS have been based solely on deposits and thus have been disproportionately distributed over SMB's.

This is clearly shown in the figures of the Belgian regulatory authority

Contributions 2011: 468 mio EUR	% of results	% of balance sheet
4 largest banks (State saved) ¹⁰	11%	0.04%
Other Banks	25%	0.09%

Figures BNB – Crefs Study, February-March 2011

Deposit Guarantee Schemes, are currently under revision in EU and an appreciable risk factors-based contribution to DGS is under discussion at EU¹¹.

⁹ Under the new framework, a State owned subsidiary of the Financial Stability Company takes over the bank's assets and part of its liabilities; the valuation of these assets will not consider intangibles like the value of relationships with customers and losses will be allocated to shareholders' equity, hybrid capital, subordinated debt and, if necessary, to senior unsecured bonds and unguaranteed deposits. Under the Bank Package III regulators retain discretionality on which investors should be assigned losses.

¹⁰ Fortis, ING, KBC and Dexia: all have received State Aids during the financial crisis.

¹¹ See Directive Proposal on Deposit Guarantee Schemes (COM(2010) 369), 7.5, "Risk-based contributions to DGSs (Article 11 and Annex I and II): Contributions from credit institutions to DGSs must be calculated according to their risk profiles in a harmonised way. In principle, contributions consist of both non-risk and risk based elements. The latter will be calculated on the basis of several indicators reflecting the risk

Risk based contributions are essential to limit unlevelled playing field and arbitrages by customers. Deposits are the fairest driver of the contribution but if the considered risk factors are RWA based (as in the current EU proposal), a double accounting of the unfavourable effect on deposit based banks, in other words traditional banking business models, is implemented. RWA mask high leverage (and consequently high risk) and thus magnify the disproportionate allocation of contributions detrimental toSMB's. And this adds on top of increasing funding costs, especially for SMBs (see following chapter). Pure risk factors, like leverage, should prevail on others here; in the current EU proposal, liquidity ratios don't receive higher weights than others and their definition is actually left to national regulation, opening the way to larger banks lobbying actions.

They are also being called for higher capital requirements, but up to now it's largely undefined if they will have to make an additional contribution to compensate for the warranties received in the recent past and granted for the future, for instance in the form of a tax or a bank levy or some parts of DGS.

It's also unclear if and how other (smaller and more prudential) banks will have to contribute to this: regulatory proposals are often generic on this subject by attributing to the whole financial sector the recent turmoil.

The EU Regulator, for instance, in the February 2011 Consultation Paper for a new tax on the financial sector, asserts that "The initial analysis of the Commission has shown that the financial sector has benefited from substantial public support during the crisis and shall therefore make a fair and substantial contribution to fiscal consolidation efforts".

profiles of each credit institution. The proposed indicators cover the key risk classes commonly used to evaluate the financial soundness of credit institutions: capital adequacy, asset quality, profitability and liquidity. The data necessary to compute those indicators are available under existing reporting obligations. Taking into account differences between banking sectors in Member States, the Directive ensures some flexibility by developing a set of core indicators (mandatory for all Member States) and another set of supplementary indicators (optional for Member States). The core indicators consist of commonly used criteria such as capital adequacy, asset quality, profitability and liquidity. Core indicators weigh 75 % and supplementary indicators 25 %. This approach to calculating risk-based contributions relies on the Commission (Joint Research Centre) reports of 2008 and 2009, and also reflects current approaches in some Member States¹². In general, the Directive requires that the total amount of contributions to be collected by DGS should first be determined in line with the target level for DGS funds; then the amount should be apportioned among DGS member banks according to their risk profiles. Consequently, the Directive provides incentives for sound risk management and discourages risky behaviour by clearly differentiating between the levels of contribution paid by the least and most risky banks (from 75 % to 200 % of the standard amount, respectively). As to the non-risk element, the contribution base is the amount of eligible deposits, as is currently the case in most Member States. However, over time, covered deposits (i.e. eligible deposits not exceeding the coverage level) will become the contribution base in all Member States as they better reflect the risk to which DGSs are exposed. "

3.2 Increasing funding cost

At GEB we consider new liquidity and capital requirements (commonly referred to as Basel3) a significant step forward in reaching a more stable banking industry and a duly correction of some biases contained in previous regimes. In particular, the QIS (Quantitative Impact Study) clearly shows an overall heavier impact of the new framework on large banks as a consequence of their generally more finance-oriented (and less traditional lending oriented) business model. These impacts can be qualified as direct, first round effects of Basel3 versus the previous framework (typically Basel2).

Nonetheless, some studies, such as the one by IIF¹², speculate that these requirements are likely to induce, as indirect or *second round effects*, higher funding costs through increased capital demand, which could in turn determine more restrictive loan conditions applied to final customers.

We, at GEB, are especially concerned about these indirect effects of the new regulatory framework; in particular we are concerned about *the asymmetry of some indirect effects* with respect to the **riskiness of business models** (as shown in appendix 2) and with respect to the **dimensions** of the market players.

In particular, liquidity ratios are likely to induce the most leveraged banks, usually the largest and finance-oriented ones (hit the most by first round effects), to deleverage their balance sheets and increase stable funding, typically retail deposits.

These banks are allowed to attract depositors through aggressive marketing campaigns, not seldom encompassing higher offered rates. We, at GEB, have collected information about the highest deposit rates offered on our markets and found surprisingly widespread aggressive pricing practices among larger and/or riskier players, not seldom having received State aids. A detail of the results can be found in Appendix 3. These practices, moreover, seem to be incompatible with EU State aid rules, according to which – as explained by the European Commission in the four communications providing detailed guidance on the criteria for the compatibility of State support to financial institutions with the requirements of Article 107(3)(b) of the Treaty on the Functioning of the European Union¹³ - the measures adopted by Member States to face the financial crisis have not to “generate unnecessary distortions of competitions between financial institutions operating in the market or negative spillover effects on other Member States”. With a view to avoiding or at least limiting negative spill over effects on competitors, all the decisions authorizing State aids to banks “include appropriate mechanisms to minimize such distortions and the potential abuse of the preferential situations of beneficiaries

¹² In particular, International Institute of Finance (IIF), march 24, 2011: the model equation below identifies the relations among desired lending rate (reward of risky assets) (r_{RA}) and the weighted average of cost of equity ($ROE/(1-t)$), funding rates (r) on Depos (D) Bonds (B), reward on Liquid Assets (LA) and non interest income (K):

$$r_{RA} = [ROE/(1-T)] * (E/RA) + r_D(D/RA) + r_B(B/RA) - r_{LA}(LA/RA) - (K/RA)$$

¹³ OJ C 270, 25.10.2008, p. 8, OJ C 10, 15.1.2009, p. 2, OJ C 72, 26.3.2009, p. 1 and OJ C 195, 19.8.2009, p. 9.

brought about by a State guarantee”¹⁴. In particular, such safeguards, which are important to avoid moral hazard, include behavioural constraints ensuring that beneficiary financial institutions do not engage in aggressive expansion against the background of the guarantee to the detriment of competitors not covered by such protection¹⁵.

Our competitors, therefore, seem to make leverage, apart from scale economies in commercial ads, on the higher rewards coming from riskier assets and aggressive finance-oriented business models to which State support can offer a LPF-distortive safety franchise.

In attracting depositors, high risk banks can leverage on another factor which are Deposit Guarantee Schemes (currently under revision in EU). A DGS offers depositors an arbitrage opportunity (free lunch) when they accept higher rewarding offers on the deposit market by curtailing the related risks (therefore a customer protected by the DGS can freely move his/her deposits to a riskier bank offering higher depo rates because he/she has no additional risks in doing so). At least in theory, a risk factor-based contribution to DGS by the banks (like the one in discussion at EU) could largely rebalance this issue; However, if finance-favouring (and lending-adverse) risk factors, such as RWA based parameters, are considered in defining the new contribution rules to DGS, an additional competitive burden would actually be added on traditional business models.

Meanwhile, due to the same distortions in risk perception, SMBs are currently facing higher funding costs due to lowered credit ratings, as explained in the previous chapter.

In other words, in an already challenging context of extremely low margins on traditional activity and exceptionally high demand for capital, SMBs and traditional business banks, as we are at GEB, are called to resist a war on strong deposit franchise with a very long list of competitive penalties.

To sum up the point, prudent traditional banks, highly liquid and operating at low leverage levels, are called to offer very high rates on deposit and on liquidity wholesale markets because of aggressive bids by larger competitors (whose ask prices on the interbank market are materially lower) and are typically called to lend money at rates lower than their funding rates; this pushes them to surrender to competition on both the funding and lending side causing them to reduce market shares or to resist to competition by taking more risks on the asset side, being impeded to relax further profitability in times of low margins and high capital needs.

¹⁴ Commission Communication of 13 October 2008, para. 27

¹⁵ see e.g. Commission Decision of 19 November 2008, Case NN 49/2008 Belgium, NN 50/2008 France and NN/45 Luxembourg concerning Dexia, para. 72, Commission Decision of 22 October 2009, Case C 29/2009 (ex N 503/2009) – Germany - HSH Nordbank, para. 80. See Also Commission Letter to the Netherlands dated 15 February 2010, Case C 11/09 (related to NN 2/10 (ex N 429/09) and N 19/10) — Recapitalization measures in favour of FBN and ABN Amro Group, para. 138 and Commission Decision of 15 June 2010, Case N 207/2010 – Sweden - Extension of the bank guarantee scheme, para. 20

3.3 Lending-adverse regulatory framework

As previously said, at GEB we consider higher and stricter capital requirements a milestone of great importance in reaching a more stable financial system.

In our opinion and as it is widely renown, some distortions were in place with the former capital framework which have been partly addressed by the new one.

The pre crisis framework

In particular, Basel 2 framework seemed very benign to leverage and finance oriented companies in associating main potential risks with traditional lending, disregarding the fact that these activities already received ample specific provisioning by most prudential banks.

For illustration purposes, suppose to consider the typical structures of an investment bank and a commercial bank (tables below): the risk weights system under Basel 2 framework offered low weightings to financial assets (in the range of 10-25% below) and a high weighting (around 75%) to customer loans. Thus RWA were 36,7 for the investment bank and 62,6 for the commercial bank.

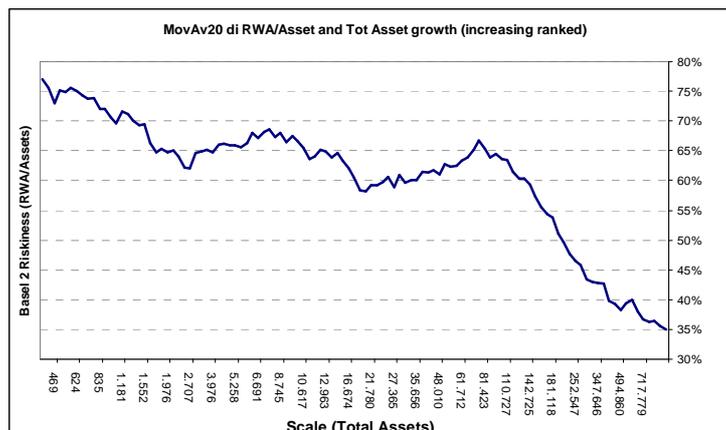
INVESTMENT BANK (DE)	UNDER BASEL II FRAMEWORK		
Common equity/RWAs	2%		
	Amount (a)	Risk Weights (b)	RWAs (c= a*b)
Total assets	100		36.7
Financial assets	65.6		10.9
<i>ow vs financial institutions</i>	36.4	10%	3.6
<i>ow vs non-financial inst.</i>	29.2	25%	7.3
Customer loans	20.3	75%	15.2
Other assets	14.1	75%	10.6
Common equity/assets	0.73		

COMMERCIAL BANKS (IT)	UNDER BASEL II FRAMEWORK		
Common equity/RWAs	2%		
	Amount (f)	Risk Weights (g)	RWAs (h=f*g)
Total assets	100		62.6
Financial assets	21.2		3.5
<i>ow vs financial institutions</i>	11.8	10%	1.2
<i>ow vs non-financial inst.</i>	9.4	25%	2.4
Customer loans	66.8	75%	50.1
Other assets	12.0	75%	9.0
Common equity/assets	1.25		

Source: ABI – Italian Banking Association

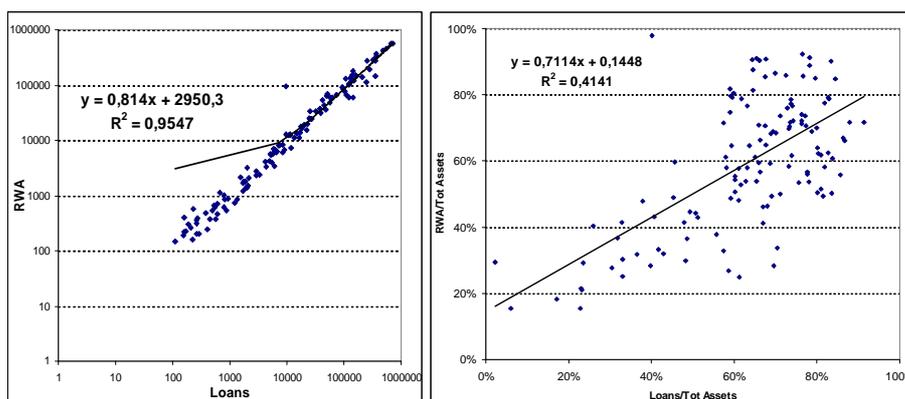
As a consequence, according to Basel 2 framework, the investment bank required a much less regulatory capital than the commercial bank because of benign finance asset risk weighting coefficients to calculate total RWA and related ratios.

The consequences of the Basel2 RWA framework can be easily seen in the following graph (referred to 2009 data) where a growing bank scale (measured as Total Assets) appears to be inversely related to risk as defined in Basel 2 framework (here calculated as RWA/Assets).



Source: Gruppo Banca Sella

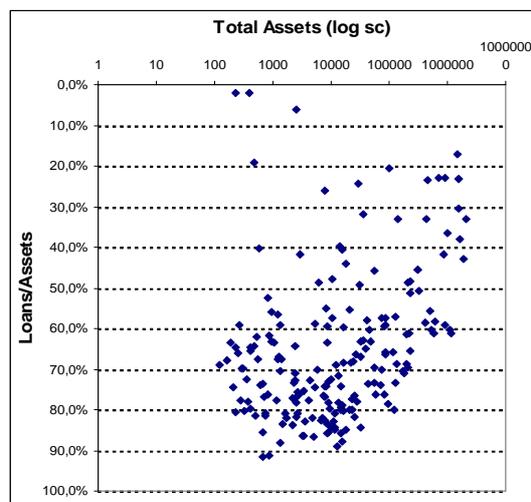
The strong inverse relation between the scale and RWA can be linked to the direct relation between the presence of loans and RWA (below). So the more lending (loans) oriented a bank is, the more RWA it has in this framework: *lending equals risk* in Basel2 framework. More advanced risk models probably allow a less strong correlation between loans and RWA (see graph on the right)¹⁶.



Source: Gruppo Banca Sella

At the same time, the relevance of loans on total assets appears inversely related to banks dimension (see graph below): *so SMBs are more often lending-oriented than large banks*.

¹⁶ The higher dispersion in the right hand graph shows that, independently of bank dimensions, lending oriented banks (with large loans to asset ratios) can have a low RWA to asset ratio, probably through more advanced risk models. The higher costs and complexity of these models makes them more suitable for large banks.



Source: Gruppo Banca Sella

By virtue of this, in the Basel2 RWA framework a bank funding itself through deposits, could have virtually reduced to zero its loans (and its support to real economy) and could have increased its positions in theoretically low risk assets (like PIGS' Government Bonds and high rating securitized assets) having therefore realized huge benefits on RWA calculations and its Tier1 position despite a low shareholders' equity contribution (so higher Return on Equity were allowed): this framework, beside lacks in the supervisory system, attributed a higher market status to a gambling bank than to a traditional lending bank.

The crisis

The recent *crisis* has shown all the limits of the paradigm "*lending equals risks*" demonstrating the potentially endless risks that uncontrolled finance can add on even the safest activity and on traditional lending as well. As the following table shows, RWA risk measures were almost uncorrelated with experienced stress situations in the recent crisis while, on the contrary, pure leverage risk measures were strongly correlated.

Mean leverage and risk-based capital ratios for stressed and non-stressed banks						
(Data is calculated as at end 2006, all capital ratios in per cent)						
Excludes countries with leverage ratio requirements						
	Working Group Sample				Broader Sample	
	Stressed		Other		Stressed	Other
Risk-based Ratios						
Total capital / RWA	10	11.77	49	12.09	15	11.57
Tier 1 capital / RWA	10	7.59	48	8.25	15	8.31
TCE / RWA	8	5.66	45	6.86	14	6.16
Leverage Ratios						
Total Capital / Assets	6	4.32	41	7.62 **	14	4.37
Tier 1 Capital / Assets	6	2.79	41	5.27 **	15	3.02
Common Equity / Assets	6	2.69	41	5.08 **	17	2.64
TCE / Tangible Assets	6	1.93	41	4.34 **	17	2.22

The symbols ***, **, * indicate that the difference is statistically significant at the 1%, 5% and 10% levels respectively. The Working Group Sample comprises up to 88 banks supplied by national supervisors from 14 countries. The Broader Sample is drawn from the Bankscope database and includes up to 117 banks from 19 countries. Each panel includes the number of banks in the sample and the relevant capital ratio.

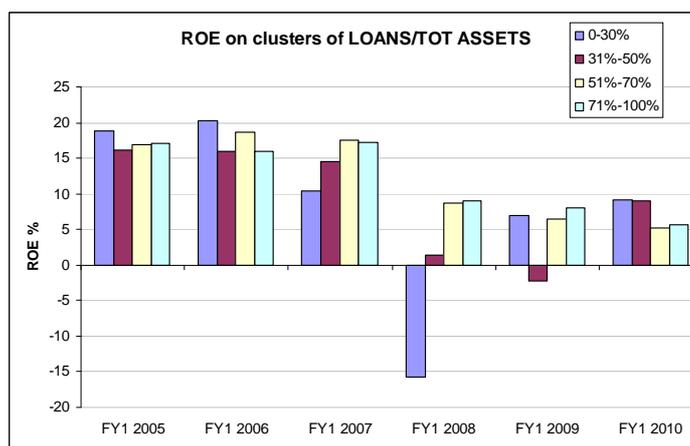
Source: BCBS (October 2010), Calibrating regulatory minimum capital requirements and capital buffers: a top-down approach.

Therefore, after the crisis a new paradigm should have inspired the new regulation:
risky behaviours (also in finance) = risk

The new framework has introduced some limiting factors on finance, as the QIS itself has clearly shown: large banks, more leveraged and more finance oriented, are hit more by the new criteria than the smaller and more traditional ones. Smaller and more prudential finance-oriented banks should be only marginally hit by direct Basel 3¹⁷ effects.

Nevertheless, the former assumption “lending equals risk” has been to some extents confirmed in the new framework and a general favour on finance remains in the current environment remains. Despite Basel3 has not been applied yet, the limits of this setting have come under pressure with the current Sovereign Debt crisis.

Traditional (lending oriented) banks have to face the new capital needs with significantly lower self financing capabilities, as shown in the following graph reporting ROE of EU banks with respect to their lending orientation.



Source: Gruppo Banca Sella, Bloomberg Data; 51 banks in Stoxx600+other listed It bnks.

This poses serious threats on the *sustainability* of traditional businesses: growth in a stricter capital framework requires even more capital, to be generated by an higher profitability; but prudent traditional banks and SMBs in particular, pay, as said, an unsustainably high price on their high liquidity and low leverage positions and are usually called to lend money at rates lower than their long term funding costs, bearing at the same time also the burden of the lending losses due to recession. This makes prudential business paradoxically unsustainable in a time when the industry is called to become more prudential.

¹⁷ As shown in appendix 2, it should be further noted that two subsectors can be identified among the finance-oriented banks: riskier, high leveraged companies (typically the SIFIs) and more traditional finance-oriented, usually smaller, banks with low leverage prudential business models: the latter are less directly hit by Basel3 but are currently facing higher compliance costs and rising funding costs which impose on them to tighten their risk profile not to perish.

As opposed to this, in the current market conditions, large non commercial banks have started again to make huge profits from trading (on risky assets), easily feeding their increased capital needs¹⁸.

In conclusion, being Basel 3 the product of a global commitment toward a greater financial stability, we at GEB are totally aware of its relevance and necessity. But the traditional business penalization which it does not definitely address, must be taken into adequate account especially when additional regulation is being introduced, avoiding further penalizations on these activities whose sustainability is currently at serious risk. And as said, when considering SMBs position, the additional asymmetric impact of second round effects of Basel3 (funding costs increase) on them should be given relevance by regulators so as to arrange some remedies in order to preserve the LPF in banking.

3.4 Disproportionally higher compliance costs

The massive reregulation process produces enormous administrative costs for compliance, largely fixed and non proportional to the covered bank's dimension. This results in a disproportionately higher duty for smaller players, while allowing scale economies for large banks like SIFIs. It also poses harmonization issues and adds complexity in the assessment of indirect, unintentional and undesirable consequences.

The pace and extent of regulatory change as proposed by the European Parliament and the European Commission remains a concern for Small and Medium-Sized banks (SMBs). All aspects of regulation are being reviewed, from the prudential and financial activities of firms, to corporate governance and through to significant changes regarding customer activities carried out by banks such as lending and investments. It may be that this is a short-term reaction to the crisis, and will reduce over time. However, the costs being incurred by SMBs are high in this transitional period, and are not proportionate to their size and activities.

Indeed, the growing scale and complexity of regulation drives a system geared in favour of economies of scale. Broadly speaking, the same rules apply to all firms regardless of size and regardless of systemic importance. High barriers of entry into the banking industry stifle competition, and very few independent houses remain. The lack of proportionality in the approach recently taken in EU Policy is felt hardest by smaller

¹⁸ "Here's why: community banks have given way to big banks and excessive industry concentration; profits are increasingly driven by risky trading; leverage is taking precedence over prudent lending; compensation is out of control. This toxic combination leads to continued taxpayer risk and threatens long-term U.S. prosperity.Such trading now is the engine of income. In 2010, the six largest bank holding companies generated \$56.1 billion in trading revenue, or 74 percent of their \$75.7 billion in pretax income. Trading revenue at these institutions distinguishes them from traditional commercial banks, which aren't typically involved in such speculative endeavors. The Big Six institutions earned more than 93 percent of the trading revenue generated by all American banks during the past two years. To say these large institutions are the same species as traditional commercial banks is akin to describing dinosaurs as reptiles - true but profoundly misleading." Robert G. Wilmers, Ch and CEO of M&T Bank Corp. (MTB).

firms. Larger banks have resources and ability to cope with the changing regulatory environment.

Greater proportionality within the rules is required to allow regulators to target those who undertake financial practices which are not prudent. The bar for proportionality should be set at a level designed to be more intrusive for systemically important institutions (SIFIs) and less intrusive on smaller or non-systemically important institutions such as SMBs. Proportionality can partly reduce the administrative costs problem created by the new regulation. A balanced approach to proportionality has to be found in EU regulations: EBA could, for instance, look for the best practices in proportionality implementation at national level and transpose them at EU level. A strict monitoring of proportionality implementation should be always conducted, and the results reviewed to ensure that the effect of new regulation on SMBs is not overlooked.

In terms of costs, we would highlight the information technology (IT) investment which is now required to ensure that all regulatory reporting is carried out in a timely and efficient manner. This has significantly increased costs and the information which SMBs are required to report. This puts on them a tremendous burden, especially on the IT infrastructure. Timescales for changes and additions to data requirements are short and IT costs and investment have rocketed.

The consciousness of the problem is increasing also abroad: Ben Bernanke in his speech before ICBA, on March 23, 2011 declared “...I think it is worth emphasizing *that the changes we will be seeing in the financial regulatory architecture are principally directed at our largest and most complex financial firms, including nonbanks.* Consequently, one benefit of the reforms should be *the creation of a more level playing field for financial institutions of all sizes.* Focusing reform on our largest, most complex financial firms makes sense.”

3.5 Future potential threats: taxation, DGS

A general principle of causation has been recalled by EU in the consultation process on additional taxes on the financial sector (details in appendix 4), citing also the large contribution to the sector that State Aids have made to high levels of budget deficits and public debt. The lower taxation argument, based on VAT exemption for banks, has also been used in sustaining the proposals.

As emerged clearly in the March 2011 EU Tax Forum, the issue is very complex and in our opinion some clarifications must be made:

The first one is on the causation principle with which we totally agree. But its implementation should consider the extreme complexity of the financial sector in which many subsectors coexist. The last crisis originated in some of them (if not only in some players), while most other subsectors have actually paid and are still paying a high price for others' mistakes.

The second concerns the undertaxation argument which is actually weak, since wide differences exist among member states and VAT is actually a further load on consumers just like a banks' additional taxation would probably be.

In taxation one must further consider that taxes on financial activities tend to move these activities in places where a fiscal benefit is granted. Forcing taxes on less mobile financial activities, like deposits, create a further burden on traditional banking activity and on small banks, which is incoherent with the causation principle on which the tax is based.

As said, Deposit Guarantee Schemes (DGS), are currently under revision in the EU and an appreciable risk factor-based contribution to DGS is under discussion at EU¹⁹. Risk based contributions are essential to limit unlevelled playing field and arbitrages by customers. Deposits are the fairest driver of the contribution but, if the considered risk factors by the regulation are RWA based (as in the current EU proposal), a double accounting of the unfavourable effects on deposit-based banks, in other words traditional banking business models, is implemented.

In order to create equal competitive conditions for all market participants, the effects arising from the mere size of individual banks must be neutralised. To simplify matters, these effects can be subsumed under the term “system relevance”. Since the (disorderly) insolvency of a systemically important market participant can jeopardise the entire financial market system as well as the real economic system, governments are virtually forced to intervene in the event of a crisis. Thereby, as already mentioned above, the risk-limiting approach of other regulations is, at least to some extent, undermined, because the insolvency sanction, which is virtually a punishment for poor economic management,

¹⁹ See Directive Proposal on Deposit Guarantee Schemes (COM(2010) 369), 7.5, “Risk-based contributions to DGSs (Article 11 and Annex I and II): Contributions from credit institutions to DGSs must be calculated according to their risk profiles in a harmonised way. In principle, contributions consist of both non-risk and risk based elements. The latter will be calculated on the basis of several indicators reflecting the risk profiles of each credit institution. The proposed indicators cover the key risk classes commonly used to evaluate the financial soundness of credit institutions: capital adequacy, asset quality, profitability and liquidity. The data necessary to compute those indicators are available under existing reporting obligations. Taking into account differences between banking sectors in Member States, the Directive ensures some flexibility by developing a set of core indicators (mandatory for all Member States) and another set of supplementary indicators (optional for Member States). The core indicators consist of commonly used criteria such as capital adequacy, asset quality, profitability and liquidity. Core indicators weigh 75 % and supplementary indicators 25 %. This approach to calculating risk-based contributions relies on the Commission (Joint Research Centre) reports of 2008 and 2009, and also reflects current approaches in some Member States¹². In general, the Directive requires that the total amount of contributions to be collected by DGS should first be determined in line with the target level for DGS funds; then the amount should be apportioned among DGS member banks according to their risk profiles. Consequently, the Directive provides incentives for sound risk management and discourages risky behaviour by clearly differentiating between the levels of contribution paid by the least and most risky banks (from 75 % to 200 % of the standard amount, respectively). As to the non-risk element, the contribution base is the amount of eligible deposits, as is currently the case in most Member States. However, over time, covered deposits (i.e. eligible deposits not exceeding the coverage level) will become the contribution base in all Member States as they better reflect the risk to which DGSs are exposed. “

applies neither to the management nor to the shareholders of systemically important institutions.

At the EU level, proposals for the restructuring and, if necessary, liquidation of systemically important credit institutions are still only being discussed, whereas in Germany, the “Act for the Restructuring and Orderly Liquidation of Credit Institutions, for the Establishment of a Restructuring Fund for Credit Institutions and for the Extension of the Limitation Period of Corporate Law Management Liability” (German Restructuring Act) came into effect at the beginning of 2011. The purpose of the Act is to protect taxpayers in the event of future crises, to make the owners of banks share in the costs of a restructuring and to solve or alleviate the “too-big-to-fail” problem. The establishment of a levy fund is to facilitate the early restructuring, reorganisation or liquidation of systemically important credit institutions without recourse to the financial support from the government. According to this Act, all banks located in Germany without maintenance obligation and guarantee obligation are liable to pay a levy, which also includes regional banks, savings banks and cooperative banks²⁰. For the time being, the target for the fund is EUR 70 billion.

However, the current concept is a massive violation of the principle of causation, for the latter would imply that the contributions to the restructuring fund would be paid only by those banks that are supported in the event of a crisis²¹. The amount of payments to be made needs to be oriented to the potential additional income that can be generated with the implicit government guarantee. Theoretically, these costs could be quantified on option price considerations; practically, the value of government guarantees can be seen from the spread differences between issues with and without government guarantees by the same issuer.

If this restructuring levy is indiscriminately imposed on all banks, it will provide a direct incentive for banks to achieve the status of a systemically important institution by increasing their size and creating corresponding risk profiles, or at least to enjoy the benefits of an implicit government guarantee.

At this point, the distinction between a restructuring fund and deposit protection has to be explained: It is often argued that the deposit protection would become obsolete through the establishment of the restructuring fund, or that it was at any rate not justified that banks bear the double burden of paying contributions to both funds. These arguments negate the different missions of the two protection systems, for averting systemic risks has never been the task of deposit protection. The purpose of deposit protection is to protect savers in the event of a crisis of an individual institution. In the past, the private banks’ deposit protection scheme has served this purpose well. The restructuring fund, in contrast, is based on the knowledge gained from the financial market crisis, which has

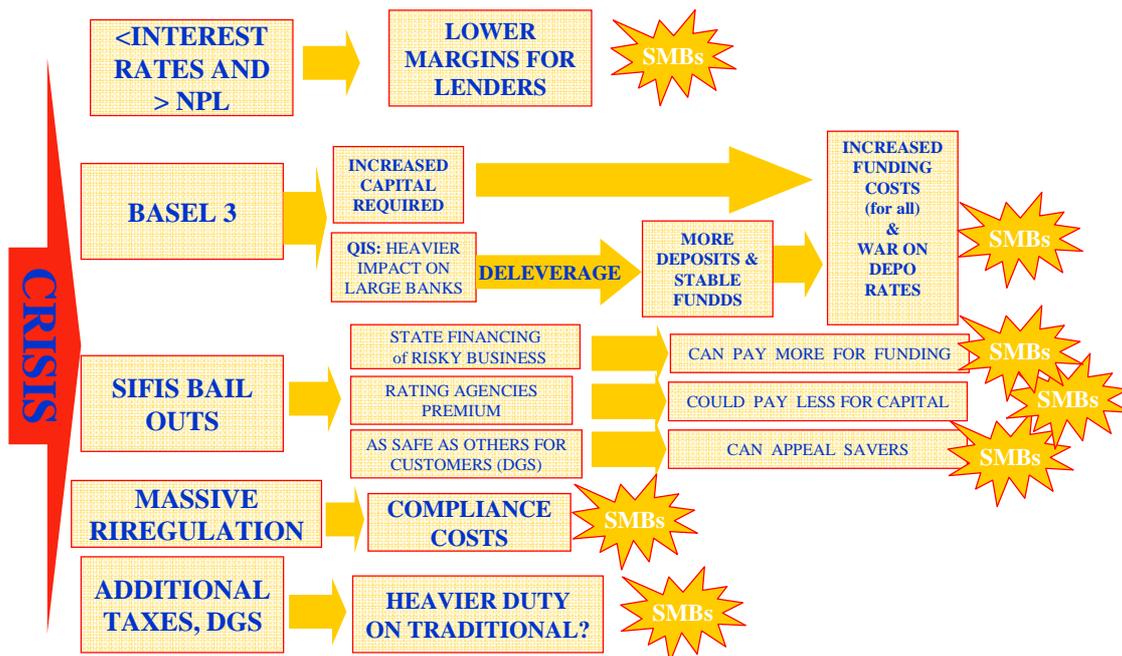
²⁰ All banks within the meaning of § 1 (1) of the German Banking Act (Kreditwesengesetz, KWG) are obliged to pay contributions. Credit institutions that are exempted in accordance with § 5 (1) No. 2 of the German Corporation Tax Act (Körperschaftsteuergesetz, KStG) and bridge banks according to § 5 (1) are not obliged to pay contributions. See also § 2 of the Act for the Establishment of a Restructuring Fund for Credit Institutions (Gesetz zur Errichtung eines Restrukturierungsfonds für Kreditinstitute, RStruktFG).

²¹ While the restructuring procedure (first stage) is available to all credit institutions, the reorganisation procedure (second stage) is designed only for systemically important institutions. See also § 7 (2) of the Act on the Reorganisation of Credit Institutions (Gesetz zur Reorganisation von Kreditinstituten, KredReorgG).

clearly revealed the systemic risks of the entire industry. Therefore, this fund requires resources in addition to the deposit protection scheme in order to be able to avert the possible risks of systemically important banks.

4 Conclusions

Our observed scenario is the following:



A general principle of causation would suggest that only banks that caused the crisis should be called to pay for it. The exceptional suspension of the exit rule from the market for (f)ailing enterprises is now, on the contrary, leading to a privileged competitive status of some players, whose price all others are called to pay, generating dangerous inefficiencies and capital misallocation in the industry.

More traditional and prudential business models, typical of small and medium banks, face a long list of competitive disadvantages which are materially reducing their profitability in a time when profit means capital generation and survival. A sustainability problem for more traditional and prudential business models came to existence.

Some evidences of the asymmetry of second round effects related to the new regulation and the unlevelled playing field have also been provided.

At GEB we are thus asking the EU Regulator:

-A better balance of the new regulation with respect to traditional banking business models.

-A better focus on leverage factors and less reliance on RWA (traditional banking adverse) measures, which would be of great utility to this purpose

-An higher proportionality in regulations with possibly a mandate to EBA to assess best practices in EU

-A better monitoring of the EU banking sector with respect to banks' dimension.

5 APPENDIX

5.1 GEB HISTORY AND SHORT PROFILES OF MEMBERS

The Groupement Européen de Banques (hereinafter “GEB”) was formed in the late seventies under the auspices of the Commission of the European Communities – Bureau des Rapprochement des Entreprises, as a group of private small and medium sized banks from certain EC countries (Italy, Belgium, France and the UK). At that time, the socio-economic context was in the process of being rapidly internationalised and the legal framework was increasingly driven by the harmonization of EU capital markets. Smaller national and regional bankers therefore felt the need to be able to continue to operate efficiently in the market in the interest of their clients, to cooperate internationally, creating personal contacts and exchanges of experiences, in order to mutually provide a better assistance to their customers, becoming progressively less “local” and increasingly interested in cross border relations in the internal market’s footsteps.

Short Profiles

Banif

Banco Internacional do Funchal, SA is a universal bank, founded in Madeira Island in 1988, with roots in the 19th century. The Bank has a leadership position in both Madeira and the Azores Islands and almost 5% market share in Mainland Portugal.

The Group has also a considerable footprint abroad, in the UK, US, Canada, Venezuela, Brazil, Argentina, Cayman Islands, Bahamas, Cape Verde, South Africa, Spain, Malta, Slovakia, Poland and Hungary.

BANIF SGPS, SA – the holding company for the BANIF Group - is the 7th largest Financial Group in Portugal. The Group employs around 4.900 people, maintains 708 points of sale, 199 of which abroad and serves more than 1,4 million customers worldwide.

The Bank’s core markets are medium sized corporates and private individuals.

Bank J.Van Breda & C

Bank J.Van Breda & C^o is a bank specialised in businesses and liberal professions, covering both professional and private needs throughout their lifetime.

Founded in Lier in 1930 by Jos Van Breda it has maintained its individuality ever since.

The bank operates with a unique approach, guaranteeing clients personal service for the systematic accumulation and protection of their assets. As their financial advisor it bears three crucial strengths:

- specialised: being familiar with the needs and concerns of SME’s and the liberal professions. the bank keeps a financial balance between their business and their private capital accumulation.
- personal: every client has a permanent client relations manager.
- proactive: and timely in taking initiatives –

External institutional funding accounts for only 5% of total assets. The bank's clients have always been the main source of financing, providing the bank with a stable source of financing, with volumes spread over a large group of clients.

Bank of Åland Plc

It is a Finnish Stock Exchange listed bank, established in 1919 with Head Office in Mariehamn.

It has offices on the Finnish mainland (Helsinki, Espoo, Turku, Parainen, Tampere and Vaasa) and in Sweden (Stockholm, Malmö and Gothenburg) and its staff accounts for approximately 750 employees.

It has various subsidiaries (Ålandsbanken Sverige AB, Ålandsbanken Fonder AB, Alpha Management Company S.A., Ålandsbanken Fondbolag Ab, Ålandsbanken Asset Management Ab (70%), Ålandbanken Equities Research Ab, Crosskey Banking Solutions Ab Ltd, Ab Compass Card Oy Ltd (Bank of Åland 66%, Tapiola Bank 34%)

Its main customers are private individuals and companies and it aims at being one bank for investors, with good financing know-how and at being the best at building and maintaining customer relationships. It also offers premium banking and private banking services and customized financing plans.

It considers itself an innovative pioneer in equity index bonds and convertible equity index bonds. It is the only bank in Finland with an "environmental account" –every year Bank of Åland donates an amount (equal to 0,2 % of the total amount of environmental account deposits) to environmental protection projects. It was the first bank in its country to introduce deposit account with Prime interest rate and to apply modern portfolio theory in asset management for individual customers.

Bankhaus Lampe KG

Bankhaus Lampe is a German independent, owner-operated private bank in Germany. Founded in 1852 in Minden in East Westphalia by Hermann Lampe, the bank is now wholly owned by the Oetker family.

Since 1949, it has operated as a limited partnership with three general partner as at today. The management is located in Düsseldorf and the Bank's headquarters are in Bielefeld.

Its three business divisions are:

- wealth advisory and wealth management for high net worth clients.
- debt and equity oriented financing services and capital-market oriented advisory services for medium-sized corporate clients.
- investment business and asset management for institutional investors.

All over the bank serves over 10,000 clients.

Banque Martin Maurel

Banque Martin Maurel is one of the very few independent, family-owned French banks with branches in several of the main French -cities: Paris, Lyon, and Marseille as well as offices in Aix en Provence, Grenoble and Neuilly-sur-Seine.

Banque Martin Maurel is the result of a merger in 1964 between two Marseilles family owned banks: Banque Martin Freres which dates from 1825 and Banque Maurel founded in 1929.

The bank provides merchant banking (credit, savings, services) and private asset management to companies of various sizes but mainly SME, institutional establishments and high-level private customers. Conventional banking services, a wide range of investment funds, all foreign transactions and individual tax and asset management consulting are available to the bank's customers.

The bank continues its expansion, with the priority given to private asset management, according to the bank's strategic plan. The loan activity business continues to be developed cautiously, taking -advantage, in line with the bank's tradition, of its excellent knowledge of its -customers and concentrating on short-term loans. In the corporate sector, the bank's risk-sharing is being extended thanks to a reinsurance mechanisms.

This policy allows regular and controlled growth through the diversification of its income sources: merchant banking, asset and portfolio management, specific services and bank-insurance.

In terms of the management of its own assets, and in order to maintain its independence from the markets, the bank always keeps large cash reserves.

C.Hoare & Co

The bank, founded in 1672, is owned by the Partners who belong to the 10th and 11th generation descendants of the founder.

The bank's mission is to provide private banking, investment management and general financial advice to 12,000 customers, the majority of whom are wealthy private individuals and their businesses and trusts. Customers are from diverse backgrounds and include financiers, business men and business women, members of the media and owners of large estates. The bank also looks after a number of professional partnerships, such as legal firms, and charities.

The strategic aims of the business are to remain family owned, self funded and independent. The bank is also committed to retaining its unlimited liability status and its strong capital position. It actively supports a range of charitable and philanthropic activities through its charity, the Golden Bottle Trust.

The business model is to offer an integrated service to customers with a seamless delivery of the right service at the right time: bank's staff are always asked to "always treat the customer as you would wish to be treated".

Gruppo Banca Sella

Gruppo Banca Sella is an independent, mid-sized Italian banking Group, wholly owned by the Sella family. It originally started with a local Bank (Banca Gaudenzio Sella & C. S.a.s). on August 1886.

The Bank decided to pursue its growth through the enlargement of its branch network, but also through acquisitions and the establishment of a banking group in 1992, which has constantly diversified since, to comprise 22 companies providing most main financial services.

The Group Head Office is in Biella, a medium size city in the wealthy north-western Italian region of Piedmont. It has achieved better geographical diversification through gradual expansion over the years, and it now covers almost all Italian regions, through its 333 branches, plus two branches in Switzerland.

The Group's main strategic activities are: retail and commercial banking, asset management, private banking, mutual funds and sicav, insurance savings, leasing, trustee services, traditional payments, credit/debit cards, POS and ATM, E-commerce, internet banking, trading online and consumer credit., bancassurance.

Since the '80s the Group has been leader in innovation and, as forerunner, it has become one of the main national operators in electronic payment systems (POS, credit cards), E-commerce and online trading. The Bank was also among the first in Italy to develop its products and services following the suggestions of customers, and to develop mobile banking and an application both for iPhone (2008) and iPad (2010).

Sparbanken Öresund

Sparbanken Öresund is the result of a merger that took place on 1st November 2010 between the two banks Sparbanken Finn and Sparbanken Gripen. The bank is the seventh largest bank in Sweden and has roots in several different savings banks, the first of which was founded in Lund in 1833.

Sparbanken Öresund is unique as a regional full service bank with strong local presence in the Öresund region in the south of Sweden. The bank's geographical area of operations is western Skåne in the south of Sweden, where it has 34 local branches in 25 places.

In partnership with the leading suppliers in the market, the bank offers competitive financial overall solutions to private individuals and small and medium sized companies.

Sparbanken Öresund is the parent company of a group that comprises subsidiaries within administration and IT support, mortgage, loans to corporate clients as well as a wholly owned real estate agency. Sparbanken Öresund's nearly 500 employees provide service to approximately 226.000 private customers, and 17.000 corporate customers.

Together with the bank's owners, two local savings bank foundations, Sparbanken Öresund is actively engaged in the development of the region.

5.2 BASEL 3 CONSEQUENCES ON ROE

To assess the asymmetric impact of the second order effects on different business models, we use the following banking profit modelling expression (1):

$$ROE = (1-T) * A/E * (r_{LA} * (LA/A) + r_{LNS} * (LNS/A) + r_{FIN} * (FIN/A) + K/A - r_D * (D/A) - r_{STF} * (STF/A) - r_{LTB} * (LTB/A))$$

which is derived as follows: defined π the after tax profit of a bank, this comes from the after tax difference between typical banking returns and costs²²:

$$\Pi = (1-T) * (r_{LA} * LA + r_{LNS} * LNS + r_{FIN} * FIN - r_D * D - r_{STF} * STF - r_B * LTB + K)$$

where **LA** stands for liquid assets and r_{LA} related returns, **LNS** are customer loans and r_{LNS} related returns, **FIN** are financial assets typical of investment banks and r_{FIN} related returns, **D** are customer deposits and r_D related costs, **STF** are short term funds and r_{STF} related costs, **LTB** are long term bonds and r_{LTB} related costs, **K** the residual part of the P&L account which, despite its huge importance and weight, is external to our aims. Then dividing both terms by E (i.e. Equity) and assuming π/E is the ROE of the bank; after dividing both terms by RA/E and rearranging, we finally obtain (1).

Now supposing we have 3 banks with different business models:

- Bank A** is a traditional commercial (deposits/loans oriented, low leverage),
- Bank B1** is a risky finance oriented bank (low depo and loans, high short term funding, high financial assets),
- Bank B2** is a prudential finance oriented bank (high deposits, high financial assets, low leverage).

For all the three models, we assume the same capital buffer over the regulatory level. They are characterized by different asset and liabilities proportions:

BANK A				BANK B1				BANK B2			
(1-T)*	60,0%			(1-T)*	60,0%			(1-T)*	60,0%		
CAP PLUS	2			CAP PLUS	2			CAP PLUS	2		
A/E*(	15,94	E/A	6,3%	*A/E*(	19,97	E/A	5,0%	*A/E*(	24,58	E/A	4,1%
*(D/A)	70,0%			*(D/A)	35,0%			*(D/A)	50,0%		
*(LTB/A)	5,0%			*(LTB/A)	15,0%			*(LTB/A)	15,0%		
*(STF/A)	15,3%			*(STF/A)	40,0%			*(STF/A)	25,0%		
*(LA/A)	24,0%	KA	6,0	*(LA/A)	18,0%	KA	2,0	*(LA/A)	35,0%	KA	5,0
		LA/DEPC	34%			LA/DEPC	51%			LA/DEPC	70%
*(LNS/A)	60%	LNS/DEF	85,7%	*(LNS/A)	30%	LNS/DEF	85,7%	*(LNS/A)	10%	LNS/DEF	20,0%
*(FIN/A)	10%	*(RA/A)	70,0%	*(FIN/A)	50%	*(RA/A)	80,0%	*(FIN/A)	50%	*(RA/A)	60,0%

²² The model is derived by the forementioned model equation in International Institute of Finance (IIF), march 24, 2011:

$$r_{RA} = [r_{OE}/(1-T)] * (E/RA) + r_D (D/RA) + r_B (B/RA) - r_{LA} (LA/RA) - (K/RA)$$

These assumptions are reflected in different Balance Sheet structures:

Assets		Liabilities	
LA	240	D	70,0
RA	70,0	STF(intbank)	15,3
o/wLoans	60,0	LTB	5,0
o/wFinAssets	10,0		
KA	6,0	KL	3,4
		E	6,3
		owregulat cap	4,3
A	100,0	L	100,0

Assets		Liabilities	
LA	18,0	D	35,0
RA	80,0	STF(intbank)	40,0
o/wLoans	30,0	LTB	15,0
o/wFin Assets	50,0		
KA	2,0	KL	5,0
		E	5,0
		owregulat cap	3,0
A	100,0	L	100,0

Assets		Liabilities	
LA	35,0	D	50,0
RA	60,0	STF(intbank)	25,0
o/wLoans	10,0	LTB	15,0
o/wFin Asset	50,0		
KA	5,0	KL	5,9
		E	4,1
		owregulat cap	2,1
A	100,0	L	100,0

The banks differ on B2 measures if we assume that around 70% of their equity is Tier1:

ASSETS	RWA pond	RWA	Regul Cap
LA	6%	1,44	0,1
Loans	75%	45	3,6
Fin Assets	25%	2,5	0,2
KA	75%	4,5	0,4
D			
STF			
LTB			
KL			
E			
		53,4	4,3

tier1 cap/Equity 70% t1 8,2%

ASSETS	RWA pond	RWA	Regul Cap
LA	6%	1,08	0,1
Loans	75%	22,5	1,8
Fin Assets	25%	12,5	1,0
KA	75%	1,5	0,1
D			
STF			
LTB			
KL			
E			
		37,6	3,0

tier1 cap/Equity 70% t1 9,3%

ASSETS	RWA pond	RWA	Regul Cap
LA	6%	2,1	0,2
Loans	75%	7,5	0,6
Fin Assets	25%	12,5	1,0
KA	75%	3,75	0,3
D			
STF			
LTB			
KL			
E			
		25,9	2,1

tier1 cap/Equity 70% t1 11,0%

Now let us assume Basel 3 framework is introduced. By doing the same assumptions on LCR and NSFR weightings and with CET1 capital representing 50% of Equity for all the banks, we obtain:

ASSETS	RWA pond	RWA	Regul Cap	LCR	NSFR
LA	6%	1,44	0,1	100%	
Loans	75%	45	3,6		85%
Fin Assets	75%	7,5	0,6		40%
KA	75%	4,5	0,4	0%	100%
D				7%	90%
STF				100%	0%
LTB				0%	100%
KL				0%	0%
E					100%
		58,4	4,7	119%	122%

CET1 cap/Equity 50% t1 5,7%

ASSETS	RWA pond	RWA	Regul Cap	LCR	NSFR
LA	6%	1,08	0,1	100%	
Loans	75%	22,5	1,8		85%
Fin Assets	75%	37,5	3,0		40%
KA	75%	1,5	0,1	0%	100%
D				7%	90%
STF				100%	0%
LTB				0%	100%
KL				0%	0%
E					100%
		62,6	5,0	42%	113%

CET1 cap/Equity 50% t1 5,6%

ASSETS	RWA pond	RWA	Regul Cap	LCR	NSFR
LA	6%	2,1	0,2	100%	
Loans	75%	7,5	0,6		85%
Fin Assets	75%	37,5	3,0		40%
KA	75%	3,75	0,3	0%	100%
D				7%	90%
STF				100%	0%
LTB				0%	100%
KL				0%	0%
E					100%
		50,9	4,1	123%	197%

CET1 cap/Equity 50% t1 6,0%

Note that B2 bank has a LCR ratio significantly under the required level (100%).

By making some assumptions on market spreads (in yellow) and rates (the same for the 3 banks), we have:

Euribor3m	1,8%	
Swap10y	3,5%	
-rD	-100	0,8%
-rSTF	-20	1,6%
-rLTB	80	4,3%
+rLA	-20	1,6%
+rLNS	90	4,4%
+rFIN	150	5,0%
+K/A	-2,0%	

and applying these to the model (1) of the 3 banks, we have:

	ROE A		ROE B1		ROE B2
Basel 2	8,7%		10,2%		9,1%
Basel 3	7%		6,1%		5,2%

Therefore all the models are penalized on ROE basis by the introduction of Basel 3 framework. The B1 bank is hit the most by the model. This is coherent with QIS results.

If we now take into account the **second round effects**, we will have higher deposit rates (rates pass to +20bp vs Euribor vs -100) and marginally higher rates on long term bonds (from +80 to +120) as a consequence of a war on more stable funding sources; no increase is supposed to happen on the less stable short term (interbanking) funding; and a conservative hypothesis of even increase with respect to issuer dimensions is applied to long term bond rates (which hardly holds if a larger bank has a State support warranty and a smaller player is downgraded by rating agencies).

An internal survey at GEB (see Appendix 3) has shown to us that the most aggressive interest rates offered on deposits are well above the Euribor level, pushing upward the funding cost of traditional, deposit based, banks.

Euribor3m	1,8%	
Swap10y	3,5%	
-rD	-20	2,0%
-rSTF	-20	1,6%
-rLTB	120	4,7%
+rLA	-20	1,6%
+rLNS	90	4,4%
+rFIN	150	5,0%
+K/A	-2,0%	

It can be assumed that rates will adapt very quickly to different demand and supply conditions, while the balance sheet structure will typically take time to adjust; active interest rates on loans will instead adapt very slowly because of marginal tightening by banks (recent bank lending surveys by ECB are largely consistent with this hypothesis): then, in the short run, by applying (1) again, we have:

	ROE A		ROE B1		ROE B2
Basel 3	0%		2,6%		-0,4%

It can be shown that the variations in ROE are a function of the ratio of deposits to assets which is, as said, higher in smaller banks (as in the fore mentioned BIS study).

Therefore, the higher funding costs hit all the banks but the more prudential and liquid models (highly depending on deposits) are penalized the most and are since asked to face higher capital needs with lower profitability than others.

Sensitivity: the model is sensitive to all the assumptions made on the structure of assets and liabilities and on the variations in the funding market rates. Given the structure shown above, sensitivity to rates variations are as follow:

rLTBrD	50	20	-10	-40	-70	-100	-130	-150
40	A=-0,9%; B1=2,8%; B2=-0,6%	A=0,7%; B1=3,5%; B2=0,7%	A=2,2%; B1=4,2%; B2=1,9%	A=3,8%; B1=5%; B2=3,2%	A=5,4%; B1=5,7%; B2=4,5%	A=7%; B1=6,5%; B2=5,7%	A=8,6%; B1=7,2%; B2=7%	A=9,6%; B1=7,7%; B2=7,8%
60	A=-1%; B1=2,5%; B2=-0,9%	A=0,6%; B1=3,3%; B2=0,4%	A=2,2%; B1=4%; B2=1,7%	A=3,7%; B1=4,8%; B2=2,9%	A=5,3%; B1=5,5%; B2=4,2%	A=6,9%; B1=6,3%; B2=5,5%	A=8,5%; B1=7%; B2=6,7%	A=9,5%; B1=7,5%; B2=7,6%
80	A=-1,1%; B1=2,3%; B2=-1,1%	A=0,5%; B1=3,1%; B2=0,1%	A=2,1%; B1=3,8%; B2=1,4%	A=3,7%; B1=4,6%; B2=2,7%	A=5,2%; B1=5,3%; B2=3,9%	A=6,8%; B1=6,1%; B2=5,2%	A=8,4%; B1=6,8%; B2=6,5%	A=9,5%; B1=7,3%; B2=7,3%
100	A=-1,2%; B1=2,1%; B2=-1,4%	A=0,4%; B1=2,9%; B2=-0,1%	A=2%; B1=3,6%; B2=1,2%	A=3,6%; B1=4,4%; B2=2,4%	A=5,2%; B1=5,1%; B2=3,7%	A=6,8%; B1=5,9%; B2=5%	A=8,3%; B1=6,6%; B2=6,2%	A=9,4%; B1=7,1%; B2=7,1%
120	A=-1,2%; B1=1,9%; B2=-1,6%	A=0,4%; B1=2,6%; B2=-0,4%	A=1,9%; B1=3,4%; B2=0,9%	A=3,5%; B1=4,1%; B2=2,2%	A=5,1%; B1=4,9%; B2=3,4%	A=6,7%; B1=5,6%; B2=4,7%	A=8,3%; B1=6,4%; B2=6%	A=9,3%; B1=6,9%; B2=6,8%
140	A=-1,3%; B1=1,7%; B2=-1,9%	A=0,3%; B1=2,4%; B2=-0,6%	A=1,9%; B1=3,2%; B2=0,7%	A=3,4%; B1=3,9%; B2=1,9%	A=5%; B1=4,7%; B2=3,2%	A=6,6%; B1=5,4%; B2=4,5%	A=8,2%; B1=6,2%; B2=5,7%	A=9,2%; B1=6,7%; B2=6,6%

Thus the main evidence of the model holds even with a modest 30 bp increase in deposit rates and no increase on long term funding costs.

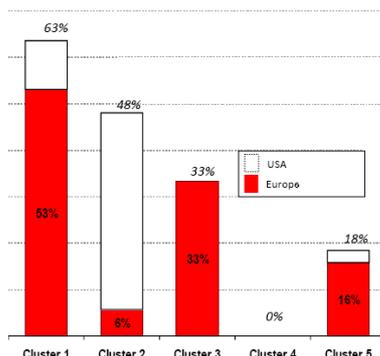
EBR-ABI business model study

A study by ABI, the Italian Banking Association, shows that a principal component based clustering analysis allows to identify 5 cluster of business models in the global banking industry²³:

- Universal wholesale banks UWB (Cluster 1)
- Traditional Universal banks TRB (Cluster 2)
- Diversified Trading banks DTB (Cluster 3)
- Asset Managers banks AMB (Cluster 4)
- Specialised Commercial banks (Cluster 5)

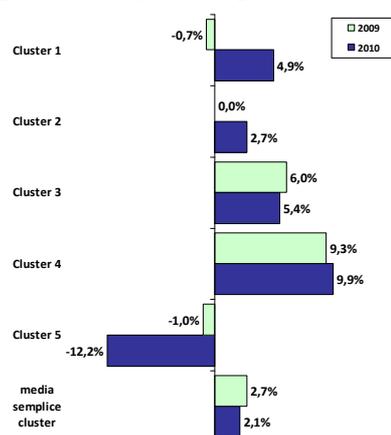
As said, these banks have received helps by respective States in a different manner (see graphs below: state help on left side, frequency distribution of the pool on right hand side).

²³ F.Masala: “Redditività e stabilità del sistema finanziario internazionale: un’analisi empirica della relazione con i modelli aziendali bancari”, ABI-EBR 2010. The study considers 259 financial companies from EU27 and US.



(source EBR, ABI - Associazione Bancaria Italiana)

These clusters of banks have been performing differently in 2010: the following graph shows that results of the banks having received more State aids have improved the most while some others (specialised commercial banks in particular, cluster 5) have worsened their profitability in the period.



(source EBR, ABI - Associazione Bancaria Italiana)

Cluster 2 and cluster 5 are, to many respects (all principal components but efficiency measures), very similar and jointly representing a *traditional commercial bank*, our bank A in the model. Our model has been since re-tested with structural balance sheet data of the companies resulting by the merge of Cluster 2 and Cluster 5, after a filtering on dimension (to exclude banks over 200 bln in assets as the aforementioned ECB study shows) to represent SMB. The results are quite in line with the previous ones despite a slight increase of profitability occurring when first round effects are considered:

	ROE A
Basel 2	1,8%
Basel 3	2%

After applying the described increase to funding rates (second round effect) we obtain consistently a sharp decrease in ROE:

	ROE A
Basel 3	-3%

5.3 INTERNAL SURVEY ON DEPOSITS

According to an internal survey conducted by GEB members (june-july 2011), the best offers on the deposit market in respective countries are as follow:

Contributor	Country	Depo rate				
BVB	Bel	3,27%	Dexia 6m			
GBS	Ita	3,25%	ING 12m (others 3,50)			
BIF	Por	4,75%	Finantia			
BMM	Fra	4,50%	LCL : 4,50% 12m (minimum 150K€)			
SP ORE	Swe	3,90%	Orust Sparbank 3m			
BHL	Ger	2.80%	IKB 12m (Postbank 3,33%)			
HOA	UK	3,50%	Barnsley Building Soc. 12m			
	Average	3,86%				

Observed best rates are all well above the reference rate. And a significant increase in last month is reported in 4 out of 6 cases. The highest rates on the market are sometimes offered by banks that have received State aid but more commonly these banks place their offer immediately under the maximum. Also non-traditional business model banks (investment banks or asset managers) are usually offering high rates on the market.